EFAMA
European Fund and Asset Management Association

Consultation Response

Brussels, 29 July 2022

EFAMA COMMENTS ON THE EUROPEAN COMMISSION'S DEBRA PROPOSAL
DEBT-EQUITY BIAS REDUCTION ALLOWANCE

EFAMA fully supports this initiative and the Commission's **efforts to encourage more companies to finance their investment through equity contributions rather than debt financing.**[1]

The Commission decided to follow a policy option that will enable the deductibility of an allowance on equity financing costs complemented by a rule to limit the deductibility of interest on debt financing instruments.

As a principle, the negative impact, and consequences that a blanket restriction on debt deduction would have on end-investors (which was our main concern considering the policy options being considered), **seem to have been avoided and this is to be welcomed**.

Nevertheless, we suggest that the right balance is struck between the tax allowances on equity vs. limiting interest deductions. Indeed, there are already interest deduction limitation rules in place across EU countries following the implementation of the EU ATAD. Such interest limitation rules were inspired by the OECD BEPS project that ensured level playing field among OECD member states.

The new interest deduction limitation rule may go beyond ensuring the minimum necessary level of protection for the EU internal market and may play a part in losing competitiveness for the EU (considering that other (non-EU) OECD countries would not be affected by similar interest limitation rules).

In addition, we noted from the Commission staff working document that other policy alternatives, and in particular an equity allowance without further interest deduction limitation, could still validly be considered and may have a more positive impact on the economy (GDP), employment and investments than the one currently put forward.[2]

We, therefore, propose to reconsider the introduction of the new interest limitation and preferably consider policy options that introduce equity allowance without further interest limitation.[3]

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[1] EFAMA's comments to the Commission's public consultation can be found here.

[2] See Commission staff working document (11.05.2022, SWD(2022) 145 final), Impact assessment report, section 6 "what are the impact of the policy options") (pages 37 onwards)

What are DEBRA's proposal main features? How are we reading the legal text?

- **This allowance** will apply to all taxpayers subject to Corporate Income Tax (CIT) in one or more Member States, including Permanent Establishments (PEs) in one or more Member States of entities that are tax residents in a third country – and **will not apply to the regulated financial undertakings listed under article 2 – which replicates article 6 (2) of the Un-shell proposal.**[4]

- **Allowance mechanics:** The deductibility of the allowance is limited to a maximum of 30% of the taxpayer's EBITDA (earnings before interest, tax, depreciation, and amortization) for each tax year. If the allowance on equity is higher than the taxpayer's net taxable income, the excess allowance may be carried forward without a time limitation. Taxpayers will be able to carry forward their unused allowance on equity which exceeds 30% of taxable income, for a maximum of 5 tax years.

- **How it will be computed?** Based on the difference between net equity at the end of the current tax year and net equity at the end of the previous tax year, multiplied by a notional interest rate. The notional interest rate is the 10-year risk-free interest rate for the relevant currency and is increased by a risk premium of 1% or, in the case of SMEs, a risk premium of 1.5%.

- **Definition of equity:** equity is defined by reference to the EU Accounting Directive. The risk-free interest rates are laid down and published for each currency by EIOPA. If the difference between the above-mentioned equity levels is a negative amount (loss), then the computation will lead to a positive amount being added to the taxable income of the company unless the taxpayer provides sufficient evidence that this is due to accounting losses incurred during the tax period or due to a legal obligation to reduce capital.

- **Anti-abuse measures:** The Directive also includes several anti-abuse measures to ensure that the rules on the deductibility of an allowance on equity are not used for unintended purposes.

- **Limitation to interest deduction:** limitation of the deductibility of interest to 85% of exceeding borrowing costs (i.e., interest paid minus interest received). Given that interest limitation rules already apply in the EU under Article 4 of the anti-tax avoidance Directive (ATAD), the Directive provides that the taxpayer will apply the rule under this proposal as a first step and then, calculate the limitation applicable under article 4 of ATAD. If the result of applying the ATAD rule is a lower deductible amount, the taxpayer will be entitled to carry forward or back the difference under Article 4 of ATAD.

- **Implementation:** Member States will have to provide specific data to the Commission on a yearly basis to allow the monitoring of the implementation and effects of the new rules.

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[3] We also note for reference that the Common Corporate Tax Base (CCTB) Proposal previously proposed by the EU Commission provided for an equity allowance together with an interest deduction limitation rule, where this later rule was similar to the current provision of EU ATAD I without further additional limitation.

[4] The DEBRA exclusion rules are based on the assumption the "bias" (and the prevention on under-equitization) is already addressed by regulatory equity requirements applicable to some financial undertakings. Please refer to the EC Staff Working Document – Impact Assessment - SWD(2022) 145 final - page 34 – where the EC explains the rationale of the exclusion rules for the Financial Sector: *"The measure will apply to all sectors except Financial Corporations. The reason for this is that an equity allowance and an interest limitation have very different impacts on Financial Companies (FCs) and Non-Financial Companies (NFCs). FCs usually have more interest received than interest paid. Therefore, the interest limitation would not apply for them since the basis (interest paid-interest received) would be negative. (…) FCs are subject to regulation on their capitalisation, which means that the issue of under capitalisation is addressed in another way."* Care needs to be taken to ensure the use of the referred draft Un-shell exclusion rule will work in practice for the purpose of DEBRA.

EFAMA's concerns

After a first review of the legal text, as well as of the Commission's working documents, **for EFAMA some elements are still raising concerns that can be easily fixed**:

- **Certainty – the definition of equity should be extended to include instruments treated as equity for tax purposes:** The draft Directive focuses on the accounting definition of equity, but Private Equity and Venture Capital players (which play an important role in SME financing) often provide quasi-equity financing, which in certain instances result in debt accounting treatment compared to equity tax treatment (e.g. certain preference shares, equity certificates, bonds, etc.). **Consideration should be given to extending the definition to instruments treated as equity for tax purposes to ensure legal certainty**.[5]

- **Flexibility – the proposed measures should not be mandatory:** While the introduction of an allowance (or notional deduction) on equity is to be welcomed, consideration should be given to making these rules optional or elective for taxpayers. **The optionality could give flexibility and avoid cumbersome compliance obligations for taxpayers that do not wish to (or cannot) avail such measure**.[6]

- **Caution with risk premium (Art. 4.2) – we need an alignment with the arm's length principle:** the currently proposed 1% / 1.5% risk premium is disconnected from the features of the underlying investment. This approach is proposed to remain simple to implement and does not harm Member States' budgets. Nevertheless, considering that the arm's length principle is deeply embedded and endorsed by both the OECD and the EU, **further consideration should be given to aligning with the arm's length principle (and underlying credit rating) for the risk premium as well**. The 1% / 1.5% could remain as the main rule to keep simplicity. The arm's length rate could be applied optionally (to be supported by Transfer Pricing). **This could make equity financing more interesting from a tax perspective (especially, in a high-interest rate environment).**

- **Alignment with ATAD I:** Additional (85%) interest limitation (Art. 6): The directive proposes to introduce an additional limitation to exceeding borrowing cost, a limitation of 85%. Further consideration should be given to **aligning the additional interest limitation with the allowance taken on equity to achieve a level playing field** (i.e. instead of the 85%, the deductible exceeding borrowing cost under ATAD I would be reduced by the equity allowance deducted in the tax year). **This could ensure that (1) taxpayers are not penalized by the additional interest limitation if they are not able to take advantage of the equity allowance (as in that case there is no need to compensate the Member States' budget for lost tax revenue), and (2) also ensure flexibility of the rules in case the use of allowance on equity would be optional/elective (see comment above).**

- **Simplification and clarifications:** The equity allowance requires tracing of evolution in equity and intragroup debt balances over several years (including losses and changes because of restructuring and reorganizations). This may create a considerable compliance burden to calculate the additions and subtractions to the net equity for every entity that is subject to these rules. **We would welcome simplifications in this area and the removal of tracing requirements. In addition, more generally, we are calling for additional definitions and clarifications of the various anti-abuse rules** (with

[5] Equity definition (Art. 3 (6)): 'equity' means, in a given tax period, the sum of the taxpayer's paid-up capital, share premium accounts, revaluation reserve and other reserves and profit or loss brought forward; The Explanatory Memorandum specifies that Equity is defined by reference to Directive 2013/34/EU (Accounting Directive).

[6] The wording of the directive suggests that the proposed measures (notional deduction on equity, including clawback) is mandatorily applicable for all taxpayers. As mentioned in the draft directive, there could be different drivers behind the choice of equity vs. debt financing (and tax could be only one of them).

examples) which are currently foreseen to ensure a smooth and consistent application by all Member States, as well as to increase legal certainty for taxpayers.

- **Specific consideration for interest limitation carve-outs:** The 85% limitation (Art. 6.1 of DEBRA) refers to the exceeding borrowing cost definition of ATAD I (Article 1, point (2), of ATAD I) which does not include the interest limitation carve-outs (such as grandfathered debt, standalone entity or debt used to fund long-term public infrastructure projects). There is no obvious reason for this, and consideration should be given to referring to these carve-outs (i.e., **clarification that the same exceeding borrowing cost and the same exceptions from ATAD I should apply**). **This could help to retain consistency and legal certainty across the various interest limitation rules, and avoid cumbersome complications/computations.**

This comment paper is being shared with the Commission and with all Fiscal Attachés/Ministers of Finance of the 27 EU Member States. **EFAMA stands ready to assist and discuss the issues raised in this document** with the technical teams of the relevant stakeholders that will work in the upcoming negotiations of this proposal.

ABOUT EFAMA

EFAMA, the voice of the European investment management industry, represents 27 member associations, 59 corporate members and 26 associate members. At end Q4 2021, total net assets of European investment funds reached EUR 21.9 trillion. These assets were managed by more than 35,000 UCITS (Undertakings for Collective Investments in Transferable Securities) and more than 30,000 AIFs (Alternative Investment Funds). At the end of Q3 2021, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 31.3 trillion.

More information is available at www.efama.org

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